RESERVE BANK OF MALAWI

Monetary Policy Statement No. 1

Preamble

The Monetary Policy Statement is issued to inform the general public about the monetary policy objectives, instruments and framework for the conduct of monetary policy. The statement will in future be issued a month after Parliament's approval of the national budget. The timing of this statement has been prompted by the expected delays in aid inflows and a growing need to improve communications to the general public.

Statement

Drawing its mandate from the Reserve Bank of Malawi Act to ensure price and financial stability, the Reserve Bank of Malawi (the Bank) will implement monetary policy with a view to consolidating gains made since May 2012 while at the same time addressing new challenges emanating from delayed disbursements by the country's development partners.

The inflation target for monetary policy is set by the National Economic Management Committee (NEMC) that is chaired by the Minister of Finance and is discussed with the International Monetary Fund (IMF) in the context of the Extended Credit Facility (ECF). The role of the Bank is to implement monetary measures necessary to attain the inflation target in the medium- to long-term. While the effectiveness of monetary policy in achieving inflation targets is continuously being reviewed, the Bank estimates that it takes between six and nine months for monetary policy actions to have full impact.

Since the economic reforms commenced in May, 2012, RBM has endeavoured to implement monetary policies using all instruments at its disposal, but it is obvious that stabilizing prices has been difficult given limited foreign exchange reserves. The sharp fluctuations in the exchange rate that the country has experienced to-date, while not unique to Malawi, have largely been due insufficient foreign reserves.

The Bank is therefore going to implement an appropriate mix of further monetary tightening and exchange rate adjustment in order to ensure continued improvements in the availability of foreign exchange in the market while at the same time dampening inflationary pressures.

The immediate goal of monetary policy is to continue to build foreign exchange reserves by intensifying the use of existing instruments and to the extent permitted by government fiscal policy. Increased foreign exchange reserves will strengthen the Bank's capacity to manage the exchange rate movements in a more credible manner and to better cushion the economy from unanticipated shocks.

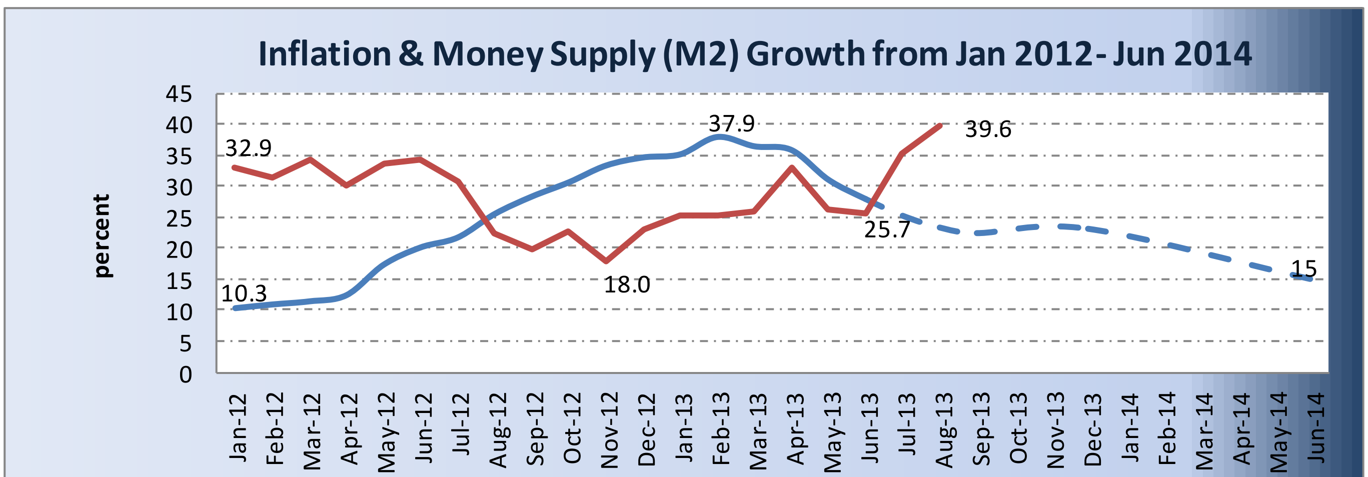
Thus, given the delay in donor flows, monetary policy will focus on protecting the country's official foreign exchange reserves at about two months of imports and build them to about three months of imports by December, 2014. The Bank is confident that these objectives are achievable against Government's commitment to restoring fiscal prudence and efficiency in expenditures in the context of the Economic Recovery Program (ERP) supported by the ECF of the IMF.

Successful delivery of this policy framework is expected to bring about a faster return to an inflation path that government had envisaged under the ERP. Achievement of a stable macroeconomic environment is crucial to the economic recovery process and to foster sustainable economic growth through achieving and maintaining low and stable inflation.

Taking into account the economy's susceptibility to endogenous and exogenous shocks, largely due to dependency on rain-fed agriculture and one major export crop, Malawi's inflation targets are set to move over time towards the SADC target of 5 per cent. Thus, the target for end-December, 2013 was initially 14 per cent and 7 per cent for end-December 2014. However, because of the expected increase in food prices and the recent postponement of donor disbursements, the end-December 2013 inflation target has been revised to 23.1 per cent and to 15% by end-June, 2014.

Notable progress has been achieved since the economic reforms commenced in the first half of 2012. Inflation shot up steadily from 12.4% in April 2012 to a peak of 37.9% in February 2013 due to the implementation of foreign exchange market liberalization and the Automatic Pricing Mechanism (APM) for fuel and utilities, as well as high prices of maize (Chart 1). A combination of improved availability of food after the harvest and consistent implementation of a tight monetary policy stance has resulted in inflation decelerating from 37.9% in February 2013 to 21.7% in September, 2013.

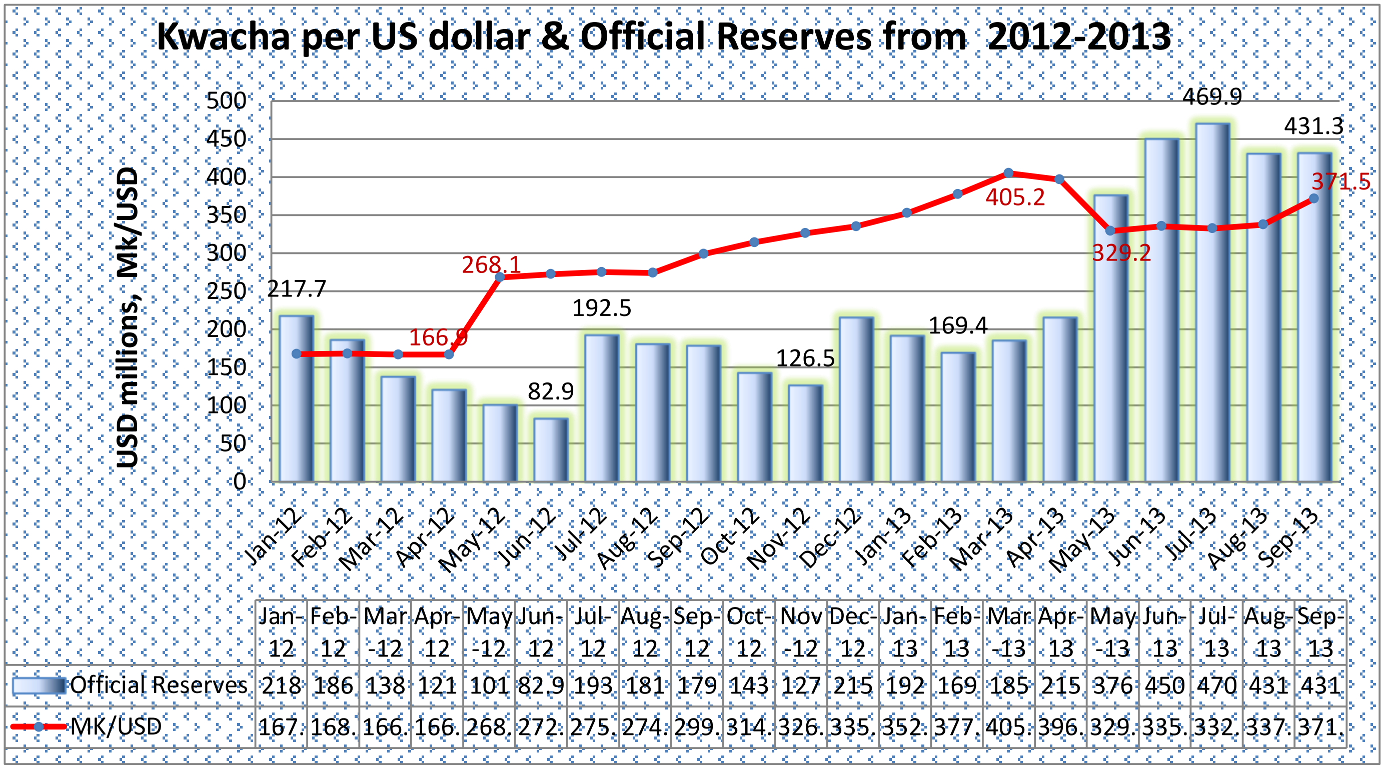
Chart 1: Inflation & Money Supply



	Jan-12	Feb-12	Mar-12	Apr-12	May-12	Jun-12	Jul-12	Aug-12	Sep-12	Oct-12	Nov-12	Dec-12	Jan-13	Feb-13	Mar-13	Apr-13	May-13	Jun-13	Jul-13	Aug-13	Sep-13	Dec-13	Jun-14
inflation	10.3	10.9	11.4	12.4	17.3	20.1	21.7	25.5	28.3	30.6	33.3	34.6	35.1	37.9	36.4	35.8	31	27.9	25.2	23.3	22.4	23.1	15
M2 Growth	32.9	31.4	34.3	30.1	33.6	34.3	30.7	22.4	19.9	22.7	18.0	22.9	25.4	25.1	25.8	33.0	26.3	25.7	35.1	39.6			

This drop was achieved on the back of the tight monetary policy stance, increased availability of food as well as a rise in foreign exchange reserves which saw the kwacha appreciate between April 2013 and July 2013 (Chart 2). Monetary authorities accumulated reserves to US$452.0 million or 2.4 months of prospective imports as at June 2013, up from US$125.3 million or 0.7 months of imports recorded in June 2012. The foreign reserves position stood at 2.3 months of imports at the end of August 2013. The main challenges faced in the 2012/13 fiscal year were rising food prices and depreciation of the Kwacha towards the end of 2012 and early 2013. The Treasury implemented the zero net domestic borrowing policy, though problems with cash management still persisted.

Chart 2: Exchange Rate & Official Reserves



Given the prevailing high levels of inflation, the Bank will continue with its tight monetary policy stance until overall inflation is brought down to single digits. This objective will be pursued through the use of a range of instruments such as open market operations (OMO), Bank rate, and foreign exchange operations. In particular, the Bank's participation in the foreign exchange market will be guided by the need to accumulate and maintain reserves at about 2 months of import while at the same time endeavouring to minimize large swings in the Kwacha exchange rate.

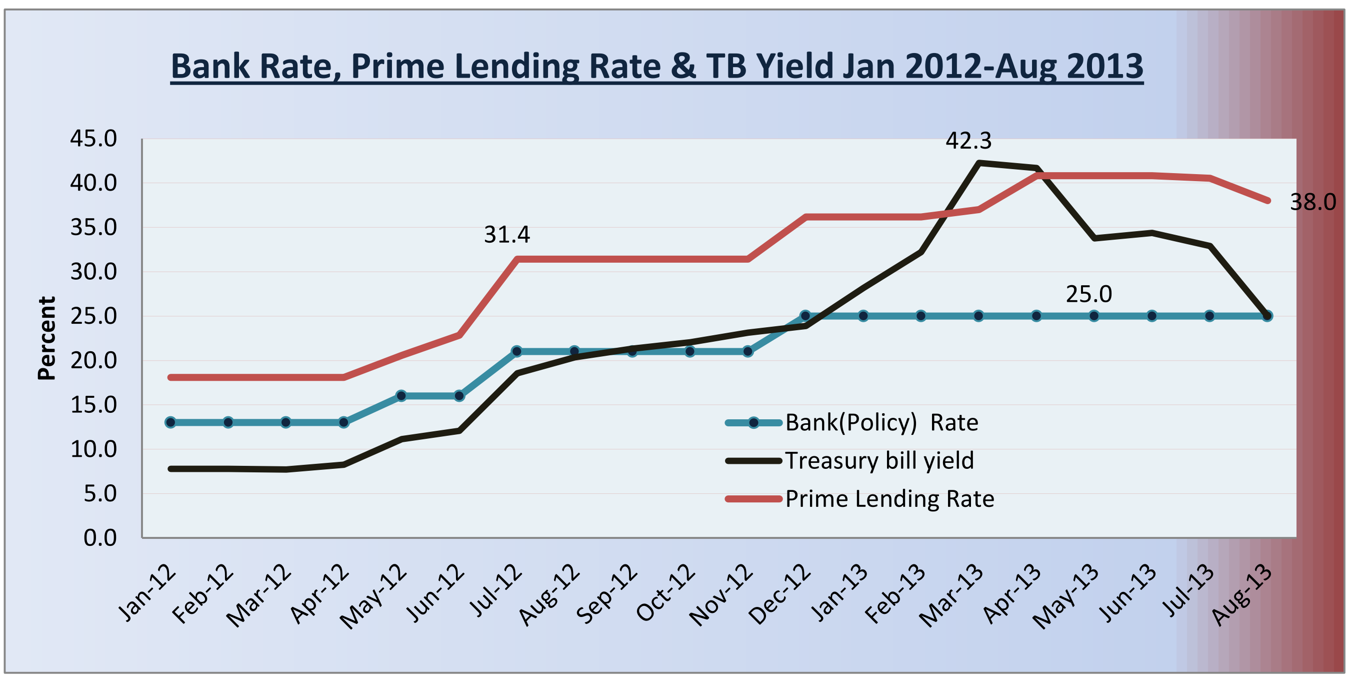
Bringing down inflation is essential to sustaining financial stability. In addition to the policies outlined above, the Bank intends to upscale its oversight and supervision of financial institutions. The Bank will also continue with its efforts aimed at improving the functioning and efficiency of financial markets and fostering development of financial markets.

It is important to point out that the stance of monetary policy is dictated by fiscal developments – specifically government's domestic borrowing requirements (DBR). In order to make sure that monetary aggregates remain in line with economic activity, and thereby avoiding fuelling inflationary pressures, increased DBR usually calls for measures to reduce bank lending to the private sector. Conversely, reduced DBR creates space for encouraging lending to the private sector. It is not possible at present to expand both government and private sector borrowing in the interest of expanding investments and jobs, without creating an inflationary spiral and depleting available foreign exchange reserves.

These complementarities and trade-offs between monetary and fiscal policies and economic growth call for continued close collaboration between fiscal and monetary authorities. This coordination does not undermine the Bank's independence in conducting monetary policy, but strengthens its role. Indeed, the Ministry of Finance and the Ministry of Economic Planning and Development participate as non-voting members of the Monetary Policy Committee (MPC) which has six voting members – three Executive Directors of the Bank and three external members. In line with the Governor's legal mandate for monetary policy, the Chair of the MPC casts the final vote when necessary to do so.

The Monetary Policy Committee met 8 times during the period June 2012-July 2013. The Committee raised the Bank rate from 13.0 per cent[1] to 16 per cent in April 2012 as part of the effort to stabilise the exchange rate and contain inflation. The MPC further raised the rate to 21.0 per cent and 25.0 per cent in July and December 2012, respectively. The Bank rate was maintained at 25 per cent from January to September 2013 (Chart 3). The LRR remained unchanged at 15.5 per cent during the entire fiscal year. Open market operations (OMO) were used extensively to contain expansion in monetary aggregates but the subsequent need to raise the Bank Rate was overtaken by an increase in interest rates as banks tried to defend their deposit positions. Thus, credit conditions tightened without an adjustment in the Bank Rate.

Chart 3: Interest Rates (January 2012-August 2013)



Monetary Policy Direction to June, 2014 will remain largely tight to contain inflation, and authorities will continue to use a reserve money targeting framework consistent with the IMF ECF program. The framework links reserve money to money supply and the growth of the latter is linked to nominal GDP growth with the excess of money supply growth over the nominal GDP growth rate reflecting demand driven inflationary pressures. Thus the Bank will ensure that credit growth is consistent with the price stability objective.

[1] The Bank rate was maintained at 13 per cent for 20 months leading to April 2012

Inflation is projected to come down to 23.1 % in December 2013 and average 27.8 % in 2013. Inflation is further projected to fall below 15 % by June 2014. However, market participant's projections of inflation for December 2013 as surveyed by the Bank in July 2013, were high at an average of 31.2 % compared to a Bank forecast of 23.1%.

The Bank projects that by December 2013 official foreign exchange reserves coverage will be slightly above 2.0 months of imports and rise to 3.5 months by end of June 2014. As a result, the Kwacha is expected to remain broadly stable with a bias towards some depreciation during the lean period.

Lastly, monetary policy is conducted in the context of what is happening not just on the fiscal front, but also in the economic sectors. Thus, while monetary policy seeks to achieve macroeconomic balance, attaining lasting relative stability will depend on success of other economic interventions including efforts to diversify the production base and improve investment climate generally. The Bank will, as a matter of course, continue with its regular interactions with stakeholders in the public and private sectors. The Bank will also enhance the production and timely dissemination of monetary data for the information of the general public.

Charles Chuka
Governor

13 November, 2013